6.01 Cost of Inventory

Overview

The cost of inventory is capitalized (ie, debited) to an inventory account. The cost of inventory includes all costs of acquisition and preparation for sale (ie, its **intended use**):

- Warehousing costs prior to sale
- Insurance, repackaging, modifications
- Freight-in paid by the buyer
- Transportation costs paid by the seller on consignment arrangements

Do **not** include:

- *Abnormal costs* for idle factory expense, unallocated fixed overhead costs, excessive spoilage, double freight, and rehandling costs (these should be expensed immediately).
- *Financing costs* – Financing costs should be reported as interest expense. This will include interest on loans obtained to purchase inventory, as well as payments made to the seller for interest on unpaid balances or early-payment discounts not taken.
- *Selling costs* – Costs incurred at the time of sale, such as freight-out paid by the seller and sales commissions, are generally recognized as selling expenses at the time of sale, consistent with the matching principle.

Returns

If goods that have been sold are returned, the seller should reduce net sales and add the cost of the items back to inventory. This should take place as soon as the seller has authorized the goods for return, so long as the actual return of the item is considered probable.

The FAR exam normally deals with merchandise inventory only. Raw materials, work in process, and finished goods inventory are usually tested in cost accounting, which is part of the BEC exam.

Inventory Costing Methods

- Heterogeneous items
  - Specific identification
    - Items that are very different, very unique, very expensive (eg, a car).
    - Must be able to identify each unit sold.
- Homogeneous items
  - FIFO – First in, First out (LISH – Last in, still here)
  - LIFO – Last in, First out (FISH – First in, still here)
  - Average inventory methods

- Dollar value LIFO

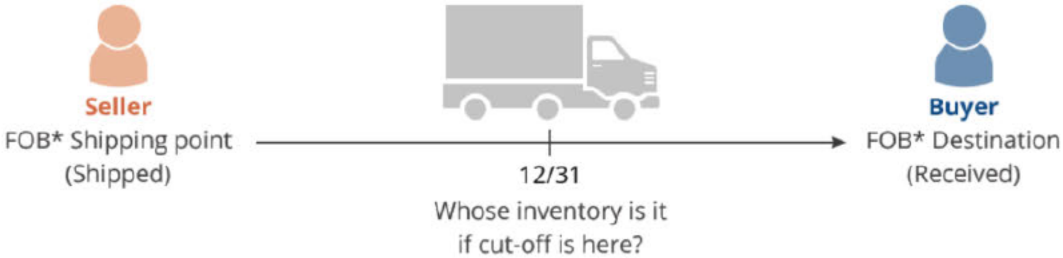
Goods in Transit

FOB Shipping Point

- Title passes to the buyer when the seller delivers the goods to a common carrier (shipped).
- Included in buyer's books at year end.

FOB Destination

- Title passes to the buyer when the buyer receives the goods from the common carrier (received).
- Included in seller's books until received by buyer.



**FOB = Free on Board*

Cost of Goods Sold (COGS)

GAAP I/S	
Operating income	Sales
Nonoperating income (other)	(COGS)
Taxes	Gross margin
Income continuing ops	(SGA)
Discontinued ops	Operating income
Net Income	
OCI	
Comprehensive income	

COGS
Beg inventory
Net purchases
Goods available for sale
(Ending inventory)
COGS

Consignment Inventory Consignor → Consignee

Occasionally, a seller and buyer will enter a consignment arrangement. This takes place when a buyer is acquiring goods for resale but only wants to purchase those goods once they have been

able to arrange the resale. In these circumstances, the potential seller (consignor) arranges for the goods to be delivered to the potential buyer (consignee) but retains legal ownership of the goods.

The consignor usually pays the transportation costs, which are added to the consignor's inventory cost (not the same as freight-out costs since no sale has occurred yet). Actually, the consignee never owns the goods since their purchase only occurs at the time they are able to resell them, at which point they are immediately reported as cost of sales.

Consignor

- Includes inventory in his balance sheet.
- Has ownership, but not possession of the goods.
- Costs incurred by consignor in transferring goods to the consignee are considered inventory costs until sold. They include:
  - The cost of the goods
  - Freight paid on shipments to consignee
  - Warehousing costs
  - In-transit insurance
- Selling costs, such as commissions and reimbursements (eg, advertising, credit card fees) paid to the consignee, are expensed in the period the revenue is recognized.

Consignee

- Items are not included in his inventory balance.
- Has possession, but not ownership of the goods.
- When sold, the sales price is given to the consignor after deducting any reimbursable costs and commissions earned by the consignee.

Two Systems for Measuring Inventory Quantities

Periodic Inventory System (physical inventory count)

Inventory quantity is determined by a physical count, usually done at year end.

- Inventory purchases are debited to purchases.
- No adjustment is made to inventory until the end of the period, when a physical inventory count is made and ending inventory is calculated.
- COGS is the plug and the exact amount of inventory shortages cannot be determined since it is buried in COGS.

At time of purchase		
Purchases	X	
A/P		X

At year end		
Ending Inventory	X	
COGS (plug at year end)	**X**	
Purchases		X

Perpetual inventory system (ongoing, real-time count)

Inventory purchases are debited to Inventory. The quantity on hand can be determined at any point in time.

At time of purchase		
Inventory	80	
A/P		80

As sales occur		
A/R	100	
Sales Revenue		100
COGS	**80**	
Inventory		80

One advantage of a perpetual inventory system is that it enables the entity to determine how much inventory is on hand at any given point in time. Not only does this assist in the management of inventory but, by performing an inventory reconciliation, comparing the recorded amounts to physical counts, management will be able to identify errors in the recording of transactions involving inventory and find indicators of potential theft.

The exam has included problems and questions calling for an **inventory reconciliation** in which the candidate is expected to compare recorded amounts to physical counts and determine the reasons for differences and whether adjustments should be made to the recorded amount.

To reconcile from recorded amount to physical count:

1. Begin with recorded amount
2. Add goods held on consignment
3. Add goods sold fob shipping point and set aside but included in the count
4. (Subtract goods in transit that were sold fob destination)
5. (Subtract goods in transit that were purchased fob shipping point)

   The result should be equal to the **physical count**.

   (Any differences will be due to errors or fraud)

To reconcile from physical count to recorded amounts, the process will be reversed:

1. Begin with the physical count
2. Add goods in transit that were purchased fob shipping point
3. Add goods in transit that were sold fob destination
4. (Subtract goods sold fob shipping point that are set aside but included in the count)
5. (Subtract goods held on consignment)

   The result should be equal to the **amount recorded**.

   (Any differences will be due to errors or fraud)